

CIFA

PART II

SECTION 3

REGULATION OF FINANCIAL MARKETS

STUDY TEXT

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PAPER NO.7 REGULATION OF FINANCIAL MARKETS

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to comply with the regulatory framework governing financial markets.

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Comply with the legal provisions relating to financial markets, including the laws of contract and agency
- Comply with the licensing regulations of the securities exchange
- Comply with the guidelines and rules of the central depository system
- Identify the offences and penalties relating to trading in securities
- Demonstrate an understanding of the processes and law of anti-money laundering
- Maintain securities registers, accounts and records

CONTENT

1. Introduction to Law

- Nature, purpose and classification of law
- Sources of law
- The court system; establishment, composition and jurisdiction;

2. Law of contract

- Definition and nature of a contract
- Classification of contracts
- Formation of a contract
- Terms of a contract
- Vitiating factors
- Illegal contracts
- Discharge of contract
- Remedies for breach of contract
- Limitations of actions

3. Law of agency

- Nature of agency

- Formation of agency
- Special classes of agents: factors, banks, brokers
- Authority of the agent
- Duties and rights of the principal and agent
- Personal liability of the agent
- Termination of agency

4. Regulation of financial markets

- Historical development of the law and regulations governing financial markets
- Need for regulation
- Regulatory strategies in financial services
- Financial regulators
- Central Bank of Kenya
- Capital Markets Authority
- Deposit Protection Fund
- Insurance Regulatory Authority
- Retirement Benefits Authority
- Sacco Societies Regulatory Authority
- Institute of Certified Investment and Financial Analysts(ICIFA)
- Professional bodies in financial services
- Regulations in the international financial markets
- The International Organisation of Securities Commissions(IOSCO) principles for self regulation

5. Regulations of capital markets

- Capital Markets Authority
- Investor Compensation Fund Board
- The Capital Markets Tribunal
- The Capital Markets Fraud Investigations Unit
- The International Organisation of Securities Commissions principles relating to the regulator

6. Regulation of financial market intermediaries

- Stockbrokers
- Stock dealers
- Investment banks
- Investment advisers
- Fund managers
- Credit rating agencies

- Collective investments schemes
- Custodians
- The International Organization of Securities Commissions(IOSCO) principles for credit rating agencies, collective investment schemes and market intermediaries

7. Raising capital in the securities market

- Types of shares
- Private offers
- Public offers;listing by introduction ,offerbytenderand rights issue
- Prospectus /information memorandum
- The International Organisation of Securities Commissions(IOSCO)principles for issuers

8. Central depository system

- The Central Depository Settlement Corporation
- Establishment of the central depository
- Duties of a central depository
- Central depository agents
- Rules and regulations of the central depository
- Remedies for breach of duties
- Security measures
- Disclosure of information by central depository agents
- Central Depository Guarantee Fund

9. Immobilisation and dematerialisation

- Meaning
- Prescription of securities for immobilisation
- Transfer to a central depository or nominee company
- Operation of securities account
- Restriction of trade in eligible securities exchange
- Establishment
- Membership
- Rules
- Listing and post listing requirements
- Self Listing of the exchange
- Cross border listing

10. Securities transactions

- Book entry of transactions and prohibition
- Records of depositors
- Suspended securities

- Suspension and delisting of securities
- Charging or mortgaging of securities
- Bonus and rights issue
- Prohibition of dealings in book entry securities
- Insider trading
- The International Organisation of Securities Commissions(IOSCO) principles for enforcement of securities regulation

11. Securities registers, accounts and records

- Interests in securities
- Restrictions in securities transactions
- Register of interests in securities
- Types of securities accounts
- Maintenance of records
- Accounts statements
- Record of depositors
- Audit of accounts, records and registers

12. Corporate governance

- Meaning of corporate governance
- Application of corporate governance principles in financial markets
- The role of capital market authorities in enforcement of corporate governance
- The International Organization of Securities Commissions(IOSCO) principles for cooperation in regulation

13. Prevention of money laundering

- Meaning of money laundering
- Component of money laundering
- Anti money laundering legislation
- Anti Money Laundering Advisory Board
- The Assets Recovery Agency
- Criminal Assets Recovery Fund
- Prevention of terrorism regulations
- Counter Financing of Terrorism Inter-Ministerial Committee: objectives, functions and powers
- The Financial Reporting Centre: objectives, functions and powers
- Due diligence requirements
- Wire transfers

14. Emerging issues and trends

CONTENT	PAGE
Topic 1: Introduction to law	7
Topic 2: Law of contract	56
Topic 3: Law of agency.....	124
Topic 4: Regulation of Financial markets.....	136
Topic 5: Regulation of capital markets.....	162
Topic 6: Regulations of financial market intermediaries.....	172
Topic 7: Raising Capital in securities market.....	195
Topic 8: Central depository system.....	203
Topic 9: Immobilization of securities.....	215
Topic 10: Securities transactions.....	244
Topic 11: Securities registers, accounts and records	259
Topic 12: Corporate governance.....	264
Topic 13: Prevention of money laundering.....	274
Topic 14: Emerging issues and trends in financial market	

TOPIC 1

INTRODUCTION TO LAW

NATURE PURPOSE AND CLASSIFICATION OF LAW

MEANING OF LAW, NATURE AND PURPOSE OF LAW

MEANING OF LAW

Law, simply put, refers to the set of rules which guide our conduct in the society and is enforceable by the state via public agencies.

Law in its general sense tends to be as a result of the necessary relations arising from the nature of things. In this sense all things have their laws. Humans, material world, superior beings and even animals all have their own laws. Simply put, the nature of these relationships tends to determine the nature of the laws.

But the intelligent world is far from being so well governed as the physical. This is because intelligent beings are of a finite nature, and consequently liable to error; and on the other, their nature requires them to be free agents. Hence they do not steadily conform to their primitive laws.

Law in general is human reason, inasmuch as it governs all the inhabitants of the earth: the political and civil laws of each nation ought to be only the particular cases in which human reason is applied.

According to the oxford dictionaries law can be defined as; The system of rules which a particular country or community recognizes as regulating the actions of its members and which it may enforce by the imposition of penalties

NATURE OF LAW

The different schools of thought that have arisen are all endeavors of jurisprudence:

Natural law school Positivism, realism among others. It is these schools of thoughts that have steered debates in parliaments, courts of law and others.

- **Natural law** theory asserts that there are laws that are immanent in nature, to which enacted laws should correspond as closely as possible. This view is frequently summarized by the maxim: an unjust law is not a true law, in which 'unjust' is defined as contrary to natural law

- **Legal positivism** is the view that the law is defined by the social rules or practices that identify certain norms as laws
- **Legal realism-** it holds that the law should be understood as being determined by the actual practices of courts, law offices, and police stations, rather than as the rules and doctrines set forth in statutes or learned treatises. It had some affinities with the sociology of law.
- **Legal interpretivism-** is the view that law is not entirely based on social facts, but includes the morally best justification for the institutional facts and practices that we intuitively regard as legal.

Generally speaking law has the following characteristics

1. It is a set of rules.
2. It regulates the human conduct
3. It is created and maintained by the state.
4. It has certain amount of stability, fixity and uniformity.
5. It is backed by coercive authority.
6. Its violation leads to punishment.
7. It is the expression of the will of the people and is generally written down to give it definiteness.
8. It is related to the concept of 'sovereignty' which is the most important element of state.

FUNCTIONS/PURPOSES OF LAW

1. It promotes peaceful coexistence/ maintenance of law and order/ prevents anarchy
2. It is a standard setting and control mechanism. Law sets standards of behaviour and conduct in various areas such as manufacturing, construction, trade e.g. The law also acts as a control mechanism of the same behaviour
3. It protects rights and enforces duties by providing remedies whenever these rights or duties are not honoured.
4. Facilitating and effectuating private choice. It enables persons to make choices and gives them legal effect. This is best exemplified by the law of contracts, marriage and succession.
5. It resolves social conflicts. Since conflicts are inevitable, the rule of law facilitates their resolution by recognizing the conflicts and providing the necessary resolution mechanism.
6. It controls and structures public power. Rules of law govern various organs of
7. Government and confer upon them the powers exercisable by them. The law creates a limited Government. This promotes good governance, accountability and transparency. It facilitates justice in the society.

CLASSIFICATION OF LAW

Law may be classified as:

1. Written and Unwritten.
2. Municipal (National) and International.
3. Public and Private.
4. Substantive and Procedural.
5. Criminal and Civil.

Written law

This is codified law. These are rules that have been reduced to writing i.e. are contained in a formal document e.g. the Constitution of Kenya, Acts of Parliament, Delegated Legislation, International treaties etc.

Unwritten law

These are rules of law that are not contained in any formal document.

The existence of such rules must be proved. E.g. African Customary law, Islamic law, Common law, Equity, Case law e.t.c

Written law prevails over unwritten law.

Municipal/ national law

This refers to rules of law that are applicable within a particular country or state. This is state law.

It regulates the relations between citizens inter se (amongst themselves) as well as between the citizens and the state.

It originates from parliament, customary and religious practices.

International law

This is a body of rules that generally regulates the relations between countries or states and other international persons e.g. United Nations.

It originates from international treaties or conventions, general principles and customary practices of states.

Public law

It consists of those fields or branches of law in which the state has a direct interest as the sovereign.

It is concerned with the Constitution and functions of the various organizations of government including local authorities, their relations with each other and the citizenry. Public law includes:

- Criminal Law
- Constitutional Law
- Administrative Law

Public Law asserts state sovereignty.

Private law

It consists of those branches of law in which the state has no direct interests as the state sovereign.

It is concerned with the legal relationships between persons in ordinary transaction e.g.

- Law of contract
- Law of property
- Law of succession
- Law of marriage
- Law of torts

Substantive law

It consists of the rules themselves as opposed to the procedure on how to apply them.

It defines the rights and duties of the parties and prescribes the remedies applicable.

Substantive law defines offences and prescribes the punishment, for example:

- The Law of torts
- The Law of succession
- The Law of contract
- The Law of marriage
- The Penal Code

Procedural law

This is adjectival law. It consists of the steps or guiding principles or rules of practice to be complied with in the administration of justice or in the application of substantive law. For example:

- The Civil Procedure Code
- The Criminal Procedure Code

Criminal law

This is the law of crimes. A **crime** is an act or mission committed or omitted in violation of public law e.g. murder, treason, theft, e.t.c. All crimes are created by parliament through statutes

A person who is alleged to have committed a crime is referred to as a **suspect**.

As a general rule, suspects are arrested by the state through the police at the instigation of the **complainant**. After the arrest, the suspect is charged in an independent and impartial court of law whereupon he becomes the **accused**.

Criminal cases are generally prosecuted by the state through the office of the Attorney General (AG) hence they are framed as R (the State) Vs Accused E.g. **R v Kamenchu**

Under the Constitution, an accused person is presumed innocent until proven or pleads guilty.

If the accused pleads not guilty, it is the duty of the prosecution to prove its case against him by adducing evidence i.e. the burden of proof in criminal cases is borne by the prosecution.

The standard of proof is beyond any reasonable doubt i.e. the court must be convinced that the accused committed the offence as charged.

In the event of reasonable doubt, the accused is acquitted. If the prosecution proves its case i.e. discharges the burden of proof, then the accused is convicted and sentenced.

The sentence may take the form of:-

1. Imprisonment
2. Fine
3. Probation
4. Corporal punishment
5. Capital punishment
6. Community service
7. Conditional or unconditional discharge

Under the Constitution, a person cannot be held guilty of an act or omission which was not a criminal offence on the date of omission or commission.

Civil law

It is concerned with the rights and duties of persons i.e. individuals and corporations.

Branches of civil law include:-

- Law of contract
- Law of torts
- Law of property
- Law of marriage
- Law of succession

When a person's civil or private rights are violated, he is said to have a cause of action.

Examples of causes of action:

- Breach of contract
- Defamation
- Assault
- Negligence
- Trespass to goods e.t.c

Causes of action are created by parliament through statutes as well as the common law and equity.

The violation of a person's civil rights precipitates a civil case or action. The person whose rights are allegedly violated sues the alleged wrongdoer hence civil cases are framed as ***Plaintiff v Defendant***.

It is the duty of the plaintiff to prove his allegations against the defendant. This means that the burden of proof is borne by the plaintiff. The standard of proof in civil cases is on a balance of probabilities or on a preponderance of probabilities i.e. the court must be satisfied that it is more probable than improbable that the plaintiff's allegations are true.

If the plaintiff proves his allegations by evidence, he wins the case and is awarded judgment which may take the form of:-

1. Damages (monetary compensation)
2. Injunction
3. Specific performance
4. Account
5. Tracing
6. Winding up a company
7. Appointment of receiver

Differences between civil wrong and crime

	CIVIL WRONG	CRIME
Definition	offence against another individual	Offence against the state
Purpose	To deal with the disputes between individuals, organizations, or between the two, in which compensation is awarded to the victim.	To maintain the stability of the state and society by punishing offenders and deterring them and others from offending.
Standard of proof	Claimant must produce evidence beyond the balance of probabilities.	Beyond reasonable doubt
Parties involved	The plaintiff, the party that is suing The defendant, the one being sued	Prosecution which represent the state and the accused
Burden of proof	Claimant must give proof however, the burden may shift to the defendant in situations of <i>Res Ipsa Loquitur</i> (The fact speaks for itself).	"Innocent until proven guilty": The prosecution must prove defendant guilty.
Type of punishment	Compensation (usually financial) for injuries or damages, or an injunction in nuisance.	A guilty defendant is subject to Custodial (imprisonment) or Noncustodial punishment (fines or community service). In exceptional cases, the death penalty.

The rule of law

The concept of the Rule of Law is a framework developed by Dicey on the basis of the English Legal system. It is also described as the due process.

According to Dicey, rule of law comprises three distinct conceptions namely:

1. **Absolute supremacy or predominance of regular law:** this means that all acts of The State are governed by law. It means that a person can only be punished for disobedience of the law and nothing else.
2. **Equality before the law:** this means equal subjection of all persons before the law. It means that no person is exempted from obeying the law. All classes of persons are subjected to the same judicial process regardless of their age, sex, creed, gender or race.
3. **The law (Constitution) is a consequence and not the source of rights:** means that the law is a manifestation of the will of the people.

Factors undermining rule of law

- Excessive power of the Executive
- Non - independent Judiciary
- Corruption
- Selective prosecution
- Civil unrest
- Ignorance of the law

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PROFESSIONAL ETHICS AND THE LAW

Principles that have to be followed by a professional accountant include:

a) Integrity

It refers to the character of the accountant. The accountant should be one who is of unquestionable morals, honest, trustworthy and forthright.

b) Professional Independence

This refers to the ability of the accountant to do his work without following any instructions from the client or any other person for any reason.

The independence ensures that the accountant will be truthful and will carry out his duties in accordance with the dictates of the profession as opposed to personal whims.

c) Confidentiality

This is the duty of secrecy. It is the duty not to divulge to third parties any information that has been received by the accountant in his capacity as such or to use such information in any way for any other purpose without the consent of the client or express authority of the law.

d) Professional Competence

Means that for a person to render professional services as an accountant he must have attained the professional ability to do so i.e. he must inter alia have the necessary qualifications after having gone through a prescribed course of study.

A person who has fulfilled the requirements of the Accountants Act⁵ in relation to qualifications is deemed to be professionally competent.

LAW AND MORALITY

Morality is the sense of judgment between right and wrong by reference to certain standards developed by society over time.

It defines standards of behavior widely accepted by a society and is binding on the conscience of the members of that society. An action that is considered to be opposed to morality will generally be frowned upon by that society. However, ***morality is not enforceable by courts of law.***

This is compared to rules of law, which are binding, enforceable and have sanctions in all cases. Wrongs in society are contraventions of law or morality or both. However, the law incorporates a significant proportion of morality. In such instances, where law and morality overlap, morality is enforced as a rule of law. Such morality becomes part of the law. E.g. Killing a person is immoral as well as a crime. So is theft.

However, certain wrongs in society contravene morality but not the law e.g. disrespects failure to provide for parents, failure to rescue a drowning person e.t.c.

What then is the relation of morality to law?

1. The existence of unjust laws (such as those enforcing slavery) proves that morality and law are not identical and do not coincide.
2. The existence of laws that serve to defend basic values such as laws against murder, rape, malicious defamation of character, fraud, bribery, etc. proves that the two can work together.
3. Laws govern conduct at least partly through fear of punishment. When morality, is internalized, when it has become habit-like or second nature, governs conduct without compulsion. The virtuous person does the appropriate thing because it is the fine or noble thing to do, not because not doing it will result in punishment.
4. As such, when enough people think that something is immoral they will work to have a law that will forbid it and punish those that do it. However if there is a law that says doing X is wrong and illegal and enough people no longer agree with that then those people will work to change that law.

BUSINESS ETHICS AND CORPORATE SOCIAL RESPONSIBILITY

In the recent years, nation have been surprised by a number of major corporate scandals triggering widespread public skepticism, shock among other behaviors towards the executives who run them. Such tend to range from inflating profits, obstruction of justice, manipulating the market, etc.